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2-22-2017

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Stockton, Matt and Broadhead, Devin, "Stabilizing Your Farm's Financial Condition and Profitability" (2017). *Cornhusker Economics*. 745.

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Cornhusker Economics

Stabilizing Your Farm's Financial Condition and Profitability

Market Report	Year Ago	4 Wks Ago	2-17-17
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	132.00	122.00	119.55
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	198.24	158.79	162.03
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	165.76	137.56	133.83
Choice Boxed Beef, 600-750 lb. Carcass.	226.24	191.65	188.93
Western Corn Belt Base Hog Price Carcass, Negotiated	51.55	63.79	74.09
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	69.65	78.99	84.57
Slaughter Lambs, woolled and shorn, 135-165 lb. National.	143.71	141.93	142.38
National Carcass Lamb Cutout FOB.	359.79	347.75	341.73
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	3.93	3.07	3.19
Corn, No. 2, Yellow Columbus, bu.	3.33	3.26	3.22
Soybeans, No. 1, Yellow Columbus, bu.	8.21	9.67	9.36
Grain Sorghum, No.2, Yellow Dorchester, cwt.	5.48	5.03	5.06
9.67Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.66	2.90	3.01
Feed			
65.00Alfalfa, Large Square Bales, Good65.00 to Premium, RFV 160-185 Northeast 111.50Nebraska, ton.	250.00	145.00	NA
Alfalfa, Large Rounds, Good Platte Valley, ton.	82.50	70.00	65.00
Grass Hay, Large Rounds, Good Nebraska, ton.	85.00	85.00	65.00
Dried Distillers Grains, 10% Moisture Nebraska Average.	134.50	107.25	111.50
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	51.50	43.50	43.75
* No Market			

Nationwide farm net income has fallen for the last three years and appears to be on trend to keep falling. Interest rates are likely to increase, as the economy seems to be warming up, resulting in increased borrowing costs and tighter credit conditions. Cash rents fell by nearly 11% on average-quality farmland in 2016 and are on a trend to continue in the coming year. In addition many farms have decreasing amounts of working capital to make up for declining incomes and high costs of production. The decrease in working capital if unchecked can decrease the stability of an operation. With no real signs that commodity values will increase and the unpredictability of the future this situation, while not dire, warrants watching.

Net farm income and working capital are vital to keep U.S. farms and ranches sustainable and healthy. While these two measures do not track the same thing, their measure of firm success and health are closely tied to each other. Net farm income (Profit) is the total earnings after expenses for the production year. This is reflected in the profit equation:

$$\text{profit} = \text{total revenue} - \text{total cost}$$

and is directly influenced by prices, productivity and costs. Working capital is the amount of capital an operation has remaining after subtracting the current 12-month liabilities from the current assets. Working capital is a way to measure an operation's ability to meet its short-term obligations and handle risks.

Recent discussions with other agricultural economists, farm management experts and bankers has resulted in the identification of five topics considered important for producers when contemplating the stabilization of working capital for their farm business.

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These five are:

1. Fix long-term interest rates now while they are low
2. Extend repayment periods which may help solve some cash flow issues
3. Reduce overhead and family living expenses
4. Reduce cost/bushel to increase profitability -- get the most bushels/dollar spent
5. Increase annual average prices received for commodities -- better marketing

Coming off a prosperous time for ag production firms and entering one where margins are much lower has resulted in unsatisfactory levels of working capital for many producers. One of the solutions suggested to this dilemma is to restructure debt (using Points 1 and 2 from above). That is annual cash needs are reduced by transferring intermediate debts to long term debt, i.e. borrowing on land assets to pay-off equipment loans. This is done with the idea that the business will not only have a healthy level of working capital, but will also have lower annual expenses making the level of cash flow sufficient to support the business. This strategy is not an ongoing repeatable solution, or at least it is limited by the equity position of the owner and the operation's future profitability. This type of solution should be viewed as an opportunity that provides time to maintain the business, which will then return to adequate levels of profitability to supply adequate levels of working capital. This type of re-

structuring is much like using land assets as a *battery* to keep the business running while the power *profitability* is restored.

To provide clarity about restructuring debt, let's use a simple example (Table 1) where your equity in land is used to refinance an intermediate debt, a tractor you purchased last year and have not yet made the payment. The reason this is being considered is that the firm lacks the cash to make the full payment without hurting its working capital ratio. (This is where Topics 1 and 2 from above play a role). Long-term borrowing extends the length of the repayment period from 3 to 7 or 10 annual payments, which reduces the annual cash requirements, thus helping the current year's assets, working capital and cash flow. Borrowing presently may be advantageous especially if interest rates are expected to increase substantially in the near future. While the amount of overall interest paid is increased, it is locked in at a low rate, versus perhaps the future costs of a short-term operating note that will likely be at a higher rate of interest. From Table 1 below it is easy to see the result of the restructured debt by extending the repayment of the \$300,000. The seven-year extension reduces annual cash needs by about \$45,000 in the first year, and the ten-year extension reduces annual cash needs by \$55,000 for the same year.

Table 1. Example of debt restructure.

Equipment Refinance

Last year a tractor was purchased new for: \$325,000

(25,000 down [cash]) under the conditions of scenario 1, from the manufacturer

Scenario 1: 0% interest, 3 annual payments

Scenario 2: 4.25% interest, 7 annual payments

Scenario 3: 5% interest, 10 annual payments

Scenario 1: Requires \$0 interest payment, but a \$100,000 annual principal payment for three years for a total cost of **\$300,000 plus the down payment, equaling \$325,000**

Scenario 2: Requires the addition of interest payments, has an annual principal payment of just over \$42,857 with total annual payments starting in year one of **\$55,607 and decreasing to \$44,679 in year seven for a total payback of \$351,000 plus the down payment, equaling \$376,000**

Scenario 3: Requires the addition of interest payments, has an annual principal payment of \$30,000 with total annual payments starting in year one of **\$45,000 and decreasing to \$31,500 in year seven for a total payback of \$382,500 plus the down payment, equaling \$407,500**

Example is a modified version of one produced by Michael B. Jacobson, President and CEO of NebraskaLand National Bank

This decrease in annual flow of cash may or may not seem trivial. The reduced flow can mean the difference between the business being able to meet annual credit requirements from a lender for working capital and giving the business the needed cushion of current assets to be considered viable or not. Thus making the firm more able to absorb some of the common risks it faces, or other cash costs including the operator's family living needs. While this might solve the working capital issue for the time being, it does not come without a cost. You will note that the seven-year loan comes at an additional interest cost of \$51,000 and the ten-year note costs an additional \$82,500.

Due to the added costs incurred by this restructuring, this is not something you would choose to do very often as it increases long-term expenses. To use a phrase, it is much like *kicking the can down the road* and this is especially concerning if future net income is not expected to increase. As a one-time or emergency fix this may be a solid strategy, but as a repetitive solution it jeopardizes the owner's equity and wealth position and threatens the continuation of the farm or ranch business. It could be argued that a shift in the business cycle created the current working capital shortage and diminished incomes; but if working capital shortage become a perennial problem and its cause remains unresolved, the question becomes: why is the business not adapting? This is where paying attention to the profit equation becomes paramount. Working capital cannot be sustained and current assets cannot increase from within the business if profits do not exist. To have positive profit requires revenues to exceed costs or cost must decrease to be lower than revenues.

There are other options that could accompany restructuring such as delaying, capital expenditures, which in turn may help increase available cash in the short term (related to Topic 4). This may or may not help increase working capital for the future depending on how the savings generated from the delay are used. However, delaying such invest-

ments will only go so far and depend on the length, size and type of delayed investments, since ultimately the business must remain productive for long-term sustainability. Another option is to sell/trade some assets to reduce debt. This is an option to consider if losing or replacing that asset does not incur issues that make the business more vulnerable to failure and if the benefit of the loss or trade exceeds its costs. The affect is much like Topic 3 from above, a reduction in family expenditures which frees up cash to be used for other purposes in the business.

Working capital is a sign of the health and resiliency of the farming or ranching business and may require some thought in terms of debt restructuring. While restructuring may fix the problem for now, the question every owner should be asking about their business is what can I do to increase profits (at least in the long run). This may require some creative thinking, i.e. offering custom services to neighbors to utilize over-capitalized equipment, reducing the bells and whistles in your seed technology if not needed, and reducing fertilizer or other inputs where possible, to name a few. Also seeking out others with expertise not present in the skill sets of the operator, i.e. a marketing specialist, which might help increase revenues by creating solid marketing plans, or strategies. There are no simple or *right* solutions that will work for everyone, but it is worth the effort to consider alternatives, or in other words to use a much over used metaphor *think outside the box*. Just like making good production choices, it is just as critical to an operation's success to use good businesses practices and make wise financial choices.

*The creation of this work was inspired and partly based on a presentation prepared by Michael Jacobson and shared with the authors.

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